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November 22, 2002

Via E-mail

Financial Crimes Enforcement Network (FinCEN)
United States Department of the Treasury
P.O. Box 39
Vienna, VA 22183-1618

Attn: NPRM - Section 352 Unregistered Investment Company Regulations

Dear Sirs or Madams:

We are writing to comment on FinCEN's proposed Unregistered Investment Company regulations under Section 352 of the USA Patriot Act, Public Law 107-56. These regulations, if adopted, will amend 31 C.F.R. Part 103, by adding a new Section 103.132. The proposed rules were published in the Federal Register on September 26, 2002 at pages 60617-60625.

Private Equity Experience of Testa, Hurwitz & Thibeault, LLP

Testa, Hurwitz & Thibeault, LLP has represented venture capital funds and other private equity firms for nearly thirty years. We presently represent over 250 separate venture capital fund groups. Our venture fund clients raised committed capital in excess of $40 billion during 2000 and 2001. We also represent a number of hedge fund and other private equity fund groups. Our venture capital and other private equity clients are located in every region of the United States, and in foreign countries including Canada, Israel and several in western Europe.

As part of our representation of venture capital and private equity fund groups, we have responsibility for drafting and negotiating with potential investors the terms of the limited partnership agreement that establishes the respective rights and obligations of the limited partner investors and the general partner, which typically is a limited partnership or limited liability company controlled by the principals of the venture capital or other private equity group. (Venture capital and other private equity funds sometimes are established as limited liability companies, but limited partnerships remain the most commonly used entity for the formation of venture capital and other private equity funds. In any event, the analysis presented below with respect to funds established as limited partnership applies with equal force to funds established as limited liability companies.) We also represent on a regular basis corporations, foundations, universities and other institutional investors making investments as limited partners in venture capital and other private equity funds. In the course of these engagements, we have reviewed numerous limited partnership agreements relating to funds that we do not represent. Through our extensive representation of both funds and limited partner investors, we have gained what we believe is a comprehensive understanding of the terms commonly found in venture capital and private equity limited partnership agreements.

Finally, we note that we have had the prior opportunity to introduce ourselves to the Department of Treasury in connection with the USA Patriot Act. Specifically, on August 16, 2002, representatives of our firm (namely, Thomas Frongillo and the undersigned) met with representatives of the Investment Company study committee chaired by Mr. Charles Klingman of the Department of Treasury. At that time, we presented our views on the application of the anti-money laundering provisions of the USA Patriot Act to the private equity industry.

Comments on the "Redeemability Requirement" As Currently Proposed.

We focus our comments on the definition of "unregistered investment company" contained in the proposed regulations, and in particular the limitation in that definition that a company (such as a fund that issues limited partnership interests to investors) is not an "unregistered investment company" unless it "permits an owner to redeem his or her ownership interest within two years of the purchase of that interest." Proposed §103.132(a)(6)(i)(B). We are concerned that the language of the proposed "redeemability requirement," as set forth in the proposing release, likely will fail in practice to conclusively exclude from the "unregistered investment company" definition many venture capital and private equity funds that FinCEN seemingly intends to place outside the coverage of the anti-money laundering program regulations.

FinCEN correctly endeavored to draft anti-money laundering regulations that exclude venture capital and private equity firms from the anti-money laundering requirements. We agree with and support FinCEN's conclusion that venture capital and private equity funds are "illiquid companies" that "are not likely to be used by money launderers." Proposing Release at 9, 67 Fed. Reg. at 60619. The proposing release observes that the "redeemability" limitation incorporated into the "unregistered investment company" definition "is likely to exclude . . . many private equity and venture capital funds." Proposing Release at 9, 67 Fed. Reg. at 60619. At first blush, it would seem that this observation would probably prove correct. Under typical limited partnership agreements governing venture capital and other private equity funds, limited partner investors make binding commitments to contribute capital to the fund on specified dates or when called to do so by the fund's general partner. These limited partnership agreements typically contain general provisions establishing that a limited partner investor has no right to withdraw its contributed capital (or profits thereon) from the fund. Under these general provisions, a limited partner investor seeking the return of invested capital must await the dissolution of the fund, which generally occurs 10-12 years after fund is formed, or distributions of cash obtained by the fund from the sale, exchange or other liquidation of securities in which the fund had invested. Particularly in the venture capital context, the time from limited partner investor's contribution of capital to the fund until the fund's return of capital to the limited partner investor can span many years, because the fund will not have cash to return to partners until its receives cash upon the sale, exchange or other liquidation of its investments, which typically are made in growth-oriented companies with significant time to liquidity.

In many venture capital and other private equity fund agreements, however, the general prohibition on a limited partner investor's right to withdraw capital typically is subject to one or more narrowly-tailored exceptions. These exceptions are typically designed to enable the fund and certain types of its limited partner investors to ensure that they comply with applicable regulatory requirements, or to avoid certain adverse and unexpected legal and tax consequences. By way of example, we have found that many private equity limited partnership agreements contain provisions specifically applicable to pension plan investors subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), 29 U.S.C. §1001 *et seq.*, and to other tax-exempt investors (such as state and other governmental pension plans, and charitable foundations). These provisions often address regulatory requirements applicable to these ERISA and tax-exempt investors. Private equity fund managers must be sensitive to these investor demands and needs surrounding these provisions. Surveys addressing recent trends venture capital investing indicate that private and governmental pension funds commit over 40% of all capital committed to venture capital funds. To provide additional detail, we offer the following observations:

- *ERISA Plan Investors*.

As a condition to an ERISA plan becoming a limited partner investor in a venture capital or other private equity fund, the managers of both the fund and the potential ERISA plan investor often will seek provisions in the limited partnership agreement that permit an ERISA plan limited partner to withdraw from the fund (or that permit the fund's managers, acting through the fund's general partner, to force the ERISA plan limited partner to withdraw from the fund) in the event that specified circumstances arise which were not present when the ERISA plan investor became a limited partner. These specified circumstances typically include a material likelihood that the ERISA plan limited partner or the fund would be in violation of ERISA (or, with respect to governmental plans, applicable state law) if the ERISA plan limited partner were to remain as a limited partner of the fund. Additionally, these specified circumstances typically include a material likelihood that some or all of the fund's assets would be deemed to constitute "plan assets" of the ERISA plan investor under ERISA, thus subjecting the fund to numerous additional and burdensome provisions of ERISA. A sample of an "ERISA withdrawal" provision commonly found in fund limited partnership agreements is attached hereto as Exhibit A.

Owing to serious adverse consequences that can result from ERISA violations or the regulatory and business impediments that would be caused by any determination that fund assets must be deemed "plan assets" subject to ERISA, potential ERISA plan investors and managers of venture capital and other private equity funds usually regard the ERISA withdrawal right as an essential prerequisite to any investment by an ERISA plan. Since a change in law or other circumstances that might require the exercise of ERISA withdrawal rights could arise at any time, however, limited partnership agreements typically place no limits on *when* the ERISA withdrawal right may be exercised. While managers of ERISA-covered pension funds must insist upon ERISA withdrawal rights in order to satisfy their fiduciary obligations to the pension funds that they manage, in our experience other fund investors do not object to such provisions, and these withdrawal rights rarely, if ever, are exercised. Nevertheless, it remains conceivable that an ERISA withdrawal could occur a short time after the ERISA plan investor makes its capital contribution. On its face, therefore, a limited partnership agreement that contains ERISA withdrawal rights could be seen as failing the "redemption requirement" in the proposed rule because the fund would, under a specified set of circumstances, "permit" an ERISA plan limited partner "to redeem his or her ownership interest within two years of the purchase of that interest." Proposed §103.132(a)(6)(i)(B).

- *Tax-Exempt Investors*.

Tax-exempt investors, such as state or other governmental pension plans and charitable foundations, also are significant investors in venture capital and other private equity funds. Tax-exempt investors place a paramount importance on protecting their tax-exempt status, and any manager of a tax-exempt fund likely would be severely faulted if the tax-exempt fund were required to pay taxes on any meaningful portion of its investment portfolio. When they negotiate investments in venture capital and other private equity funds, therefore, tax-exempt fund managers typically insist that the limited partnership agreement include a withdrawal right that may be exercised if a change of law or applicable regulations or some action on the part of the fund (outside of the control of the tax-exempt investor) gives rise to a material likelihood of the imposition of special taxes or that the continuation of the tax-exempt partner in the limited partnership would result in a material violation or breach by such tax-exempt limited partner of applicable federal or state law. Similar to the ERISA withdrawal right, the withdrawal right commonly made available to tax-exempt investors is exercisable at any time after the material likelihood of additional taxes or a violation or breach arises, even if that situation arises only shortly after the tax-exempt limited partner contributed capital to the limited partnership. Because a tax-exempt withdrawal provision could be viewed as permitting a tax-exempt limited partner to redeem its interest within two years, this common provision could prevent many venture capital and other private equity funds from availing themselves of the "redeemability requirement" under the proposed rule. A sample of such a withdrawal provision applicable to a private, tax-exempt foundation is attached hereto as Exhibit B.

- *Bank Holding Company Act Investors*.

The managers of investors that are subject to regulation under the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841 *et seq.*, frequently will negotiate with venture capital or other private equity fund managers for provisions in the limited partnership agreements that will permit an investor subject to the Bank Holding Company Act to withdraw capital and profits from the fund in amounts necessary to maintain its interest in the fund below the maximum level established in the Bank Holding Company Act and Regulation Y promulgated thereunder. As typically formulated, this right arises only in if a Bank Holding Company Act limited partner's percentage ownership interest in the fund appears likely to exceed the maximum permissible level, owing to other limited partners' contribution defaults or other circumstances outside of the Bank Holding Company limited partner's control. Nevertheless, a limited partnership agreement that contains standard Bank Holding Company withdrawal rights would arguably fail the proposed rule's "redemption requirement" because the fund would, albeit under a specified set of circumstances, "permit" a Bank Holding Company Act limited partner "to redeem his or her ownership interest within two years of the purchase of that interest." Proposed §103.132(a)(6)(i)(B). A sample of a withdrawal provision applicable to Bank Holding Company Act investors is attached hereto as Exhibit C.

* * * * *

The foregoing examples are by no means exhaustive. Similar withdrawal rights routinely are requested by and provided to other major investors in venture capital and other private equity funds, such as insurance companies, telecommunications companies and other businesses in highly-regulated industries, and certain foreign investors (particular where such foreign investors have special taxation concerns relating to the tax laws of the country in which they reside). In our experience, these withdrawal provisions, although tailored to the special requirements of the particular investor, typically permit withdrawal only where (1) a statute or regulation is adopted, amended or otherwise changed, resulting in requirements or obligations (applicable to the limited partner investor and/or the fund itself) that were not present when the fund was formed and the investor became a limited partner, or (2) circumstances unfavorable to a particular limited partner arise through the operation or conduct of the fund's affairs that were outside of the such limited partner's control (*e.g.*, the fund undertakes certain investment activities or, owing to payment default and expulsion of another limited partner, a particular limited partner's ownership percentage of the fund rises to an impermissible level). Based on our experience representing both funds and investors in the venture capital and private equity industries, these withdrawal provisions routinely are granted by fund managers and accepted by all limited partners, even those limited partners that cannot avail themselves of the withdrawal right. (Investors presumably appreciate that a fund manager will not lightly permit such withdrawals, since any reduction in the fund's capital tends to reduce the prospects for enhanced returns and often lowers the base upon which the fund manager's compensation is determined.) Yet these appropriate and now standard withdrawal provisions arguably could be interpreted to "permit[] an owner to redeem his or her ownership interest within two years of the purchase of that interest." If the proposed regulation is adopted as presently drafted, it is possible that relatively few venture capital and other private equity funds will be in a position to conclusively conclude that they fall outside of the definition of "unregistered investment company" and therefore are not subject to the anti-money laundering program requirements. We believe that this outcome is inconsistent with FinCEN's expectation and intent with respect to the proposed Unregistered Investment Company regulations.

Finally, it should be noted that the withdrawal provisions noted above do not create any meaningful opportunity for money laundering activities. First, a limited partner typically must prove (sometimes with the legal opinion of a law firm acceptable to the fund's managers) that an event permitting a withdrawal in fact has occurred. Second, venture capital or other private equity limited partnership agreements usually permit withdrawal payments to reflect the illiquid nature of the fund's investments. In other words, in the rare situations in which a withdrawal right actually arises, fund managers typically are permitted to return capital to the withdrawing limited partner in the form of investment securities or promissory notes that may remain illiquid for potentially a long time. In short, while withdrawal provisions are found in a many venture capital and other private equity limited partnership agreements, the presence of these provisions in no way undermines FinCEN's determination that venture capital and other private equity funds are "illiquid companies [that] are not likely to be used by money launderers." Proposing Release at 9, 67 Fed. Reg. at 60619.

Proposed Revisions to "Unregistered Investment Company" Definition.

We urge FinCEN to a revise the redeemability limitation set forth in the proposed definition of unregistered investment company. We suggest revised language below. The revised redeemability limitation that we are recommending maintains the general rule regarding redeemability over the two-year period, but recognizes that certain redemptions are acceptable within such two-year period. Specifically, we recommend two changes to the definitions section of the proposed rule. First, we suggest that the following definition be added to subparagraph (a) of the proposed rule:

> The term *discretionary redemption* means a redemption of an ownership interest in a company that is effected for discretionary reasons, and specifically excludes any redemption that is effected based on the material likelihood that such redemption is necessary to maintain compliance with applicable statutes, rules, regulations, rulings or orders, or to avoid adverse changes in the owner's legal, regulatory or tax status or position that may occur as a consequence of circumstances outside of such owner's control.

Second, we suggest that the current text of subparagraph (B) of section (a)(6)(i) be stricken in its entirety, and replaced with the following language.

> (B) That gives an owner the right to effect a discretionary redemption of his or her interest within two years of the purchase of that interest.

We believe that the "discretionary redemption" principle that we are recommending strikes the appropriate balance between ensuring that would-be money launderers are not able to launder money through venture capital and other private equity limited partnerships by making capital contributions and capital withdrawals on a relatively rapid basis, and ensuring that a many venture capital and private equity funds are excepted from the anti-money laundering program regulations, notwithstanding that their limited partnership agreements permit redemptions under the limited and narrowly-tailored set of circumstances described in this letter.

We appreciate your consideration of our comments on the proposed Unregistered Investment Company regulations. We would be happy to answer any questions that you may have or to supply you with additional information that you might request. Please feel free to contact me at (617) 248-7562.

Very truly yours,

/s/ Howard R. Rosenblum

Howard S. Rosenblum

<u>Exhibit A</u>

<u>Sample ERISA Limited Partner Withdrawal Provision</u>

15.2.2 ERISA Withdrawal.

15.2.2.1 General.

Notwithstanding any provision in this Agreement to the contrary, any Limited Partner which is an ERISA Partner may elect, upon written notice of such election to the General Partner, to withdraw from the Partnership, or upon written demand by the General Partner shall withdraw from the Partnership, at the time and in the manner hereinafter provided, if either such ERISA Partner or the General Partner shall obtain and deliver to the other an opinion of counsel (which counsel shall be reasonably acceptable to both such ERISA Partner and the General Partner) to the effect that there is a material likelihood that:

(a) Such ERISA Partner (or any employee benefit plan subject to ERISA that is an investor, directly or indirectly, in such ERISA Partner) or the Partnership would be in material violation of ERISA if such ERISA Partner were to continue as a Limited Partner of the Partnership; or

(b) All or any portion of the assets of the Partnership would constitute "plan assets" of such ERISA Partner for the purposes of ERISA, and would be subject to the provisions of ERISA to substantially the same extent as if owned directly by the ERISA Partner.

The costs of obtaining or seeking an opinion of counsel for purposes of this 15.2.2.1 shall be borne by the ERISA Partner.

15.2.2.2 Notice of withdrawal.

In the event of the issuance and delivery of the opinion of counsel referred to in 15.2.2.1, the General Partner shall promptly provide to each Partner a copy of such opinion, together with a copy of the written notice of the election of such ERISA Partner to withdraw or the written demand of the General Partner for withdrawal, as the case may be.

15.2.2.3 Cure period.

The General Partner shall have, in its sole discretion, a period of 90 days following receipt of such counsel's opinion (or delivery of notice by the General Partner to such ERISA Partner demanding its withdrawal, if applicable) to attempt to eliminate the necessity for such withdrawal to the reasonable satisfaction of such ERISA Partner and the General Partner, whether by correction of the condition giving rise to the necessity of such ERISA Partner's withdrawal, by amendment of this Agreement, by effectuation of a transfer of such ERISA Partner's interest in the Partnership to a substituted Limited Partner, or otherwise, If requested to do so by such ERISA Partner, the General Partner shall use commercially reasonable efforts to locate a purchaser of such ERISA Partner's interest in the Partnership.

15.2.2.4 Time of withdrawal.

If such cause for withdrawal is not cured within such 90-day period, then such ERISA Partner shall withdraw from the Partnership as of the last day of the fiscal quarter of the Partnership during which such 90-day period expires or as of such earlier date as may be agreed to by the General Partner, in its sole discretion (such date being herein referred to as the "**ERISA Withdrawal Date**").

15.2.2.5 Effects of withdrawal.

Effective upon the ERISA Withdrawal Date, such ERISA Partner shall cease to be a Partner of the Partnership for all purposes and, except for its right to receive payment for its Partnership interest as hereinafter provided, shall no longer be entitled to the rights of a Partner under this Agreement, including without limitation the right to receive distributions during the term of the Partnership pursuant to Article 7 and upon liquidation of the Partnership pursuant to Article 10, the right to receive allocations pursuant to Article 8 and the right to vote on Partnership matters as provided in this Agreement.

15.2.2.6 Distributions to Withdrawing ERISA Partner.

(a) As promptly as practicable following the ERISA Withdrawal Date, there shall be distributed to such ERISA Partner, in full payment and satisfaction of its interest in the Partnership, an amount equal to the amount which such ERISA Partner would have been entitled to receive pursuant to Article 10 if the Partnership had been liquidated on and as of the ERISA Withdrawal Date and each of the Partnership's assets had been sold on such date for its fair market value determined pursuant to 14.4. No approval of the Advisory Board or of the Partners shall be required prior to the making of such distribution.

(b) For purposes of determining the amount of the distribution to be made to such ERISA Partner, and the value of each of the Partnership's assets, the Partnership's annual or quarterly financial statements, as the case may be, prepared in accordance with 14.3.1 and 14.3.2, respectively, for the period ending on the ERISA Withdrawal Date shall be deemed to be conclusive unless either the withdrawing ERISA Partner or the General Partner notifies the other in writing, either before the ERISA Withdrawal Date or not more than 20 Business Days thereafter, of such Person's objection to such valuation, indicating briefly the reason(s) therefor. If within 20 Business Days after such an objection to a determination of value has been made, a substitute value has not been agreed upon by the General Partner and such withdrawing ERISA Partner, the General Partner shall submit the dispute to an independent appraiser selected by the General Partner and approved by the withdrawing ERISA Partner. If there shall be more than one Limited Partner that is a withdrawing ERISA Partner, the independent appraiser referred to in the preceding sentence shall be approved by a majority in interest of such withdrawing ERISA Partners.

(c) Any distribution to the withdrawing ERISA Partner(s) pursuant to this 15.2.2.6 shall be made in cash, cash equivalents, securities of Portfolio Companies or a recourse note of the Partnership bearing interest at a fixed rate equal to the applicable federal rate of interest then in effect, with a maturity no later than the date of the Partnership's final liquidating distribution. If securities of Portfolio Companies are being distributed, such securities shall be distributed in a manner consistent with 7.1.2.2 to the extent practicable, unless otherwise required by law or contract. In the event that any distributions in kind are to be made, the General Partner and such withdrawing ERISA Partner(s) shall cooperate to minimize, to the extent reasonably practicable, the risk that any of them will be treated as engaging in a "prohibited transaction" within the meaning of Section 406 of ERISA or Section 4975 of the Code as a result of such distribution.

Sample Tax-Exempt Foundation Limited Partner Withdrawal Provision

(Note: must be read in conjunction with ERISA withdrawal provision; See Exhibit A)

15.3.3 Foundation Partner Withdrawals.

If any Tax-Exempt Partner that is a private foundation (a "**Foundation Partner**") shall obtain an opinion of counsel (which opinion and counsel shall be reasonably acceptable, as to form, substance and choice of counsel to the General Partner), to the effect that, as a result of a change in law or the exercise of the Limited Partner rights to reduce Remaining Commitments pursuant to 6.6 or withdrawal rights pursuant to 15.2.2 or this 15.3, there is a material likelihood that the continuation of the Foundation Partner as a Limited Partner of the Partnership will result in (a) the imposition of excise taxes pursuant to Subchapter A of Chapter 42 of the Code (other than Sections 4940, 4942, 4947 and 4948 thereof), or (b) a material violation of, or a material breach of the fiduciary duties of its trustees or governing board under, any federal or state law applicable to private foundations or any rule or regulation adopted thereunder by any agency, commission or authority having jurisdiction, then such Foundation Partner may completely or partially withdraw from the Partnership in accordance with the provisions of this Article 15 as if such Foundation Partner were an ERISA Partner to the minimum extent necessary to avoid such excise taxes or such violation; *provided*, *however*, that if such Foundation Partner so proposes, the General Partner shall use commercially reasonable efforts (taking into consideration the need to act quickly to prevent or cure the adverse consequences referred to above) to locate a buyer for all or a portion of such Foundation Partner's interest in the Partnership.

Sample Bank Holding Company Act Limited Partner Withdrawal Provision

(Note: must be read in conjunction with ERISA withdrawal provision; See Exhibit A)

15.3.4 Bank Holding Company Partner Withdrawals.

If at any time, as a result of proposed reductions in any Limited Partners' Remaining Commitments pursuant to 6.6, withdrawals by Limited Partners pursuant to 15.2.2 or this 15.3 or distributions to other Partners, or for any other reason, the General Partner expects the Capital Account of any Bank Holding Company Act Limited Partner to exceed 24.99% of the total Capital Accounts of all Partners (or such greater or lesser percentage as may be permissible hereafter under the Bank Holding Company Act and Regulation Y promulgated thereunder), the General Partner shall immediately notify such Bank Holding Company Act Limited Partner and permit such Bank Holding Company Act Limited Partner to immediately partially withdraw from the Partnership in accordance with the provisions of this Article 15 as if such Bank Holding Company Act Limited Partner were an ERISA Partner to the minimum extent necessary to maintain such Bank Holding Company Act Limited Partner's total investment in the Partnership at a level below 25% (or such permissible percentage) of the Partnership's total capital.